



CHARTERED CERTIFIED ACCOUNTANTS

Article topic: Financial Reporting

IAASB Proposals for Financial Liabilities

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On 11 May 2010, the International Accounting Standards Board (IASB) published for comment their proposed changes to the way financial liabilities are to be accounted for. These changes were as a result of investor feedback and the IASB's work on financial assets and their issuance of IFRS 9: *Financial Instruments* which was issued in November 2009 but applies only to financial assets.

The IASB's 'project objective' is to:

“Address the volatility in the income statement (P&L) caused by changes in the credit risk of a financial liability ('own credit'). In particular the ED (Exposure Draft) proposes changes in the accounting for financial liabilities that an entity chooses to measure at fair value.”

The closing date for comments to be received by the IASB is 16 July 2010.

'Own Credit'

The IASB's project objective refers to the concept of 'own credit'. This refers to the accounting effect of changes in the credit risk of a financial liability. It works on the concept that changes in a financial liability's credit risk will affect the fair value of that financial liability. Therefore, in today's economic climate, when an entity's credit worthiness deteriorates (as we have seen quite a lot over the last few months') then the fair value of its issued debt will also decrease and vice versa.

Where an entity uses fair value as a means of valuing their financial liabilities, such fluctuations in an entity's credit worthiness will cause a gain or (loss) to be recognised in the income statement (profit and loss). Because many investors find the accounting treatment of financial liabilities valued at fair value through profit or loss confusing, this prompted a discussion paper which was published in June 2009: *Credit Risk in Liability Measurement*.

Investor Response

The IASB have asked for responses from investors concerning financial liabilities and received over 90 responses. In general, the responses confirmed that:

- Profit and loss volatility caused by own credit does not provide useful information (with the exception for derivatives and liabilities held-for-trading).
- Investors did not want the IASB to develop a new measurement method, but information on the effects of own credit can still be useful.

The Proposals

The IASB have considered the responses they have received and are proposing a limited change which will address the issue of own credit for financial liabilities. They are proposing a two-step approach.

The 'two-step' approach would address the issue of P&L volatility as follows:

- The fair value change of liabilities under the fair value option would be recognised in P&L.
- The portion of the fair value change due to own credit would be reversed out of P&L and recognised in 'other comprehensive income', therefore bypassing the P&L.

Illustration – Current Requirement

Entity A Inc has a financial liability which it values under the fair value option. In the year to 31 December 2009 the total change in this fair value amounts to £250.

The whole of this fluctuation would be recognised in the P&L.

Illustration – Proposed Requirement

Facts as above, but under the 'two-step' approach we would firstly ascertain the change in fair value, which is still £250. However, we would go a step further and also determine the change in fair value from 'own credit'. For the purpose of this illustration, let us assume that the change in fair value from own credit amounts to £30.

Step 1 - $(£250 - £30) = £220$ would be recognised in P&L.

Step 2 - The £30 which is a change in fair value from own credit would be recognised in 'other comprehensive income' and not P&L.

The IASB are not proposing any other change for financial liabilities.

The overall effect of this proposal would be to eradicate the volatility in the P&L caused by changes in own credit, though information about own credit will still be available for investors. The IASBs proposals would only apply to those financial liabilities an entity 'chooses' to measure at fair value and therefore financial liabilities which are 'required' to be measured at fair value (such as derivatives and liabilities held-for-trading) would fall outside the scope of this proposal. The proposals will largely affect large financial institutions.

Structured Debt

Some financial liabilities often contain the requirement to split certain debt instruments into those instruments which are measured at amortised cost for example splitting a 'vanilla' instrument and a derivative component which is measured at fair value (this is sometimes referred to as 'bifurcation'). The IASB do not propose any changes in this respect.

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